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Dear Bill

### **Ofgem Consultation – Price Control Pensions Principles (Third Consultation Document)**

Thank you for the opportunity to comment on Ofgem's third consultation on Price Control Pension Principles, published on 16 October 2009. We note that your consultation presents your "minded to" position and have therefore sought to focus our comments on the principles and practicalities of your suggestions.

#### Historic Liabilities

We are pleased to note that Ofgem has accepted the legacy issues DNOs face with historic liabilities and Protected Persons legislation.

#### Future Service Costs and Benchmarking with Employment Costs

We note the proposal to introduce, for the DPCR5 period only, an incentive for DNOs to share in any reduction or increase in costs (including any new deficit created) relative to "efficient" costs at a rate of 50 percent or the rate used in the IQI mechanism.

If Ofgem are to introduce an incentive in this area, ENW believes that the success of any scheme will be reliant on the identification of an appropriate mechanism for determining the "efficiency" of any change in costs. We believe this proposal represents a significant and inappropriate increase in risk for DNOs and therefore would favour the use of the IQI incentive rate, merely as a device to minimise this risk increase. We have some specific concerns with the proposal to use the PPF7800 Index and deal with these later in the letter.

With regards to an incentive mechanism post DPCR5 and the use of the IQI and benchmarked costs it is difficult to comment on this proposal in detail without the further information from Ofgem as to how this will work in practice. ENW would be happy to engage with Ofgem in further discussions to agree a methodology that is sensible and practical.

### Deficit Repair Periods

We note the Ofgem suggestion of a move to a 15 year deficit period and understand the rationale for such an approach. We also note that in the slides used in the Seminar on 9<sup>th</sup> November to support such a position the fact that ENW had recently agreed a period of just over 10 years was used to support your position on a 15 year time period.

It is essential to point out, based on the actual experience of our recent discussions with the Trustees of our scheme, that unless there is further unequivocal guidance from the Pensions Regulator gaining agreement to periods significantly beyond 10 years will be extremely difficult. This could in turn produce cash flow and financeability issues for DNOs.

We believe, therefore, that this supports the 10 year deficit repair period proposal as this is consistent with the trigger points used by the Pensions Regulator. Should Ofgem continue with their "minded to" position then we would urge Ofgem to work with the Pensions Regulator to jointly issue suitable guidance for employers and Trustee bodies.

In addition, we note that in the Pension Regulators latest edition of the annual analysis of recovery plans (published 0th November 2009), the weighted average length of the recovery plans of schemes submitting valuations in the period 22nd September 2007 to 21st September 2008 (the latest period analysed) was 8.3 years. In addition the analysis states that only 12% of all recovery plans are greater than 10 years and a chart in the analysis suggests only 5% of schemes have a recovery plan of longer than 15 years. This indicates that the proposed period of 15 years is much higher than that used by most other UK pension schemes.

### Valuation Dates

We are pleased to note that Ofgem have chosen not to use conformed valuations and understand the rationale for using the valuation data as at 31 March 2010.

### PPF Levy

We note Ofgem's option for dealing with PPF levies on a case by case basis and would support this. For example, if one or more of the DNOs were to combine their pension schemes, would Ofgem still apply the same cap to the combined scheme even though the assets and liabilities are significantly bigger? Having a cap equal to a fixed monetary amount could also be problematic as the PPF are going to be reviewing their calculation method during the price control period.

### PPF7800 Index

The proposed use of this index is one our biggest concerns. Whilst accepting that Ofgem are seeking to fulfil their statutory duties and meet the pension principles we do not believe that the PPF7800 index is a valid way of doing so.

The nature and construct of the index – together with the proposed band of 5% will, we believe, mean it is inevitable that most schemes will end up having to convince Ofgem of their efficiency and possibly why their scheme has moved differently to the wide range of

influences affecting the performance of the overall index. Detailed below are factors that make the PPF7800 index unsuitable.

Rather than use the index ENW would support further use of a report from the Government Actuary's Department (GAD) as has already been used by Ofgem. This would allow the use of both objective data on performance etc but also allow for an overlay of other valid considerations such as differing maturity of schemes.

It would be beneficial to agree in advance the terms of reference for the report from GAD and ENW would be happy to work with Ofgem to complete this exercise.

#### Factors which suggest the PPF7800 Index is unsuitable

There are a number of areas in which the calculation of liabilities for the PPF7800 Index will be different from the calculation of a particular scheme's ongoing funding level.

- The Section 179 valuation only takes account of benefits that would be provided by the PPF in the event a scheme fell into the PPF. These differ significantly from actual benefits provided by almost all UK schemes (for example, the PPF does not provide pension increases on pensions accrued before 6th April 1997 and benefits are subject to maximum amounts).
- The valuation assumptions reflect the cost of buying out PPF benefits with an insurance company, and, unlike funding assumptions, contain limited allowance for investment performance over and above bond yields.

In addition to differences in the liability calculation, a particular pension scheme's funding levels will not move in line with the general PPF7800 Index because:

- Schemes have their own asset allocations – for mature schemes or immature schemes these could be very different from the average UK Scheme; and
- The proportion of deficit paid off each year by NWOs may be a different proportion from the average scheme in the PPF7800 Index. This will be particularly true if a 15 year deficit period is set by Ofgem.

It is also important to note that only this month the PPF have updated the financial and demographic assumptions for calculating liabilities for the Index. This change has reduced liabilities by around 7% (£71.2 billion) at 31 October 2009. This reinforces the potential unsuitability of this Index. The one-off reduction this month is more than the 5% bandwidth proposed by the PPF.

Also, set out below are a few additional technical areas in which the calculation of liabilities for the PPF7800 Index will be different from the calculation of a particular scheme's ongoing funding level.

- The PPF regularly review the assumptions used for Section 179 valuation calculations and update them when appropriate to reflect changes in the cost of buying out pension scheme benefits in the insurance market. This can and has led to step changes in the PPF7800 Index funding level on a monthly basis. For example in April 2008, the PPF made changes to the discount rate and mortality assumptions and this reduced scheme liabilities, and so improved the PPF7800 funding level, by £50 billion.
- The PPF will also update calculations to allow for the most recent data submitted by pension schemes. Where up-to-date information is not available, the PPF estimates the current Section 179 funding level for each scheme from previously submitted information. The PPF updated their dataset earlier this year and this improved the PPF7800 funding level by £15 billion.
- The PPF Section 179 calculations use a prescribed mortality table and this may not be appropriate for schemes which are large enough to justify a scheme specific table.
- The Section 179 valuation methodology does not allow for any increases in pensionable salaries while most funding valuations will allow for future expected salary increases.

#### Stranded Surplus

We note that Ofgem intends to review on a case by case basis how any future stranded surplus are dealt with. Should this arise we would welcome debate with Ofgem as to how using such a surplus to de-risk the scheme could be to the future benefit of consumers.

#### Bulk Transfers

We note the Ofgem suggestion that consumers should not fund any increase in deficit related to bulk transfers. We do not think this approach is appropriate in respect of bulk transfers from schemes which are related to regulated businesses. Efficient costs related to such liabilities would be allowed had such a transfer not taken place. We suggest Ofgem deal with the treatment of bulk transfers on a case by case basis taking into account wider commercial considerations which result in the bulk transfer being made.

#### Buy In and Buy Out

We would support the Ofgem position to reviews these on a case-by-case basis.

#### Conclusion

We are very aware of the need to be conscious of the costs of pensions and the impact on customer bills but still believe that, as evidenced by the GAD report, the NWOs have taken a responsible and efficient approach so far. We still therefore believe that any change in approach should be limited. However, should Ofgem decide to proceed as outlined in the document we would welcome the opportunity for further engagement on some of the issues identified that require more work prior to implementation.

I hope you find these comments constructive. If you have any questions on any of the points made do not hesitate to contact me or Paul Taylor, our Corporate Services Director.

Yours sincerely,

**Paul Bircham**  
**Regulation Director**  
**Electricity North West Limited**